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In the Supreme Court of the United States

OCTOBER TERM, 1976

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

STANDARD LIFE & ACCIDENT INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum opinion of the Tax Court (Pet. App. A 1a–8a) is not officially reported. The opinion of the court of appeals (Pet. App. B 9a–23a) is reported at 525 F. 2d 786.

JURISDICTION

The judgment of the court of appeals (Pet. App. C 24a–25a) was entered on November 6, 1975. The court of appeals denied a petition for rehearing with suggestion for rehearing *en banc* on January 9, 1976 (Pet. App. D 26a–27a). By orders dated March 30 and April 26, 1976, Mr. Justice White extended the

time for filing a petition for a writ of certiorari to and including June 6, 1976. The petition was filed on June 4, 1976, and was granted on October 4, 1976 (A. 142). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a life insurance company that reduces its federal tax liability by including in its "reserves" the amount of the net valuation portion of its deferred and uncollected premiums on the assumption that the full annual premiums on all of its outstanding policies have been paid on their anniversary dates, must apply the same assumption and likewise include the full amount of its deferred and uncollected premiums in its "assets" and "gross amount of premiums" under Sections 805(b)(4) and 809(c)(1) of the Internal Revenue Code of 1954, or else must exclude such premiums altogether in computing its "reserves," "assets" and "gross amount of premiums"; or whether, as the court of appeals held, it may exclude its deferred and uncollected premiums from "assets" and "gross amount of premiums" but nevertheless include the net valuation portion of such premiums in its reserves.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 801, 802, 804, 805, 809, 810 and 818 of the Internal Revenue Code of 1954 as amended (26 U.S.C. (1958 ed., Supp. II)), and of Treasury Regulations on Income Tax, Sections 1.801–4, 1.805–5 and 1.809–4 (26 C.F.R.), set forth in the Appendix, *infra,* pp. 1A–23A.

STATEMENT

A. THE STATUTE

The Life Insurance Company Income Tax Act of 1959, as set forth in Sections 801–820 of the Internal Revenue Code of 1954, provides a three-phase procedure for the taxation of life insurance companies.[1] The primary categories of income subject to tax are "taxable investment income" (as defined in Section 804) and "gain from operations" (as defined in Section 809). "Taxable investment income" is, as the term implies, income from interest, dividends, and the like. "Gain from operations" is a broader category encompassing total net income from all sources, *i.e.,* investment income plus other income, principally underwriting income from premiums.

Pursuant to Section 802(b), the total tax base of a life insurance company to which the ordinary corporate rates are applied is the sum of the tax bases derived from computations under each of the three phases. The Phase I tax base (Section 802(b)(1)) is the smaller of "taxable investment income" or "gain from operations." The Phase II tax base is equal to 50 percent of the excess, if any, of the gain from operations over taxable investment income (Section 802(b)(2)). Finally, the portion of a company's "gain from opera-

[1] Section 4 of the Life Insurance Company Income Tax Act of 1959, 73 Stat. 141, makes the Act applicable to all taxable years beginning after December 31, 1957. Pursuant to Section 843 of the Code, life insurance companies are required to report their income on a calendar year basis.

tions" or underwriting income that is not taxed under Phase II becomes the Phase III tax base when such income is made available to shareholders (Section 815). See *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235 n. 2.

For purposes of the Phase I and II tax bases, the determination of the total tax base involves a series of computations directed toward arriving at the fundamental categories of "taxable investment income" and "gain from operations."[2] The statute recognizes that life insurance companies are required to compute their projected future liabilities to their policyholders by establishing policyholder reserves to meet future claims and that the annual additions to those reserves should be free of tax. Section 801(b)(1) of the Code defines life insurance reserves and the statutory scheme provides a method for establishing the amount which, for tax purposes, is deemed to be added each year to these reserves.

Accordingly, the computations of both "taxable investment income" and "gain from operations" provide a mechanism for excluding from the total tax base those portions of investment and premium income that must be held to meet policyholder obligations. The payment of premiums necessarily results in

[2] There is a variation between the Phase I and II methods of computing the company's share of "investment income." Simply stated, the Phase I computation is based upon the company's actual earnings experience, while the Phase II computation permits the use of the company's assumed rate of interest.

the creation of a reserve liability reflecting amounts that the company must invest at an assumed rate of interest to meet future death claims. All other elements of the tax computation remaining constant, as the reserves and the amount of income necessary to cover the reserves increase, the federal tax base will correspondingly decrease.

(1) *Taxable Investment Income.*—With respect to determining "taxable investment income," the statutory computations are generally directed toward dividing the investment income for the taxable year on an item-by-item basis between a nontaxable "policyholders' share" deemed necessary for policyholder reserve obligations and a taxable "life insurance company's share." This is accomplished by dividing the company's "investment yield"[3] by the "assets" of the company[4] to derive the company's actual earnings rate. This rate, after adjustment,[5] is then multiplied

[3] Section 804(c) defines "investment yield" as "gross investment income," less specified deductions, including investment expenses, real estate expenses, and depreciation and trade and business expenses, subject to certain exceptions and limitations.

[4] Section 805(b)(4) defines "assets" as "all assets of the company * * * other than real and personal property (excluding money) used by it in carrying on an insurance trade or business." Thus, a building owned by the company to house its offices and its furniture and fixtures are excluded from the computation of its "assets."

[5] The adjusted earnings rate (which the statute calls the "adjusted reserves rate") equals the current earnings rate, or the average of the current earnings rate and the rates from the four years prior to the current year, whichever is lower. See Section 805(b)(1), (2) and (3).

by the company's adjusted life insurance reserves for policyholders.[6] The resulting product is the exclusion from the company's tax base for the amounts of investment income that are considered necessary for tax purposes to cover its life insurance reserves.

The foregoing computation may be expressed by the following formulae:

$$(1)\quad \frac{\text{Investment Yield}}{\text{Assets}} = \text{Earning Rate}$$

$$(2)\quad \text{Earning Rate} \times \text{Reserves} = \text{Tax Exclusion}$$

$$(3)\quad \frac{\text{Investment Yield}}{\text{Assets}} \times \text{Reserves} = \text{Tax Exclusion}$$

or

$$\text{Investment Yield} \times \frac{\text{Reserves}}{\text{Assets}} = \text{Tax Exclusion}$$

These formulae demonstrate that the proportion of the company's reserves to its total assets controls the fractional amount of the investment income that will be excluded from tax. Thus, as "reserves" increase in pro-

[6] Adjusted life insurance reserves are the company's life insurance reserves for policyholder obligations, adjusted for the difference between the assumed interest rate used by the company in computing the reserves and the actual earnings rate. The reserve is reduced by 10 percent for every 1 percent by which the applicable earnings rate exceeds the company's assumed rate. The resulting figure—the adjusted life insurance reserves—is then multiplied by the company's adjusted earnings rate. To the amount so calculated are added pension plan reserve requirements and interest paid during the taxable year, all of which are excluded from the copmany's tax base. See Sction 805; *United States* v. *Atlas Life Ins. Co.*, *supra*, 381 U.S. at 236 n. 4.

portion to the company's assets, the tax exclusion will likewise increase.

(2) *Gain from Operations.*—The company's "gain from operations" includes its income from all sources, less certain specified deductions. Since "gain from operations" includes the element of investment income, the computation of "gain from operations" is further directed toward taking into account income from other sources, principally underwriting income. Underwriting gains result when the premium charged for a policy exceeds the company's costs in providing the coverage. Thus, in addition to its share of investment income, the principal item in computing "gain from operations" is the "gross amount of premiums and other consideration * * * on insurance and annuity contracts * * *." (Sec. 809(c)(1)).

The specified deductions (Section 809(d)) include noninvestment expenses, such as underwriting expenses, salaries, general overhead, and claims paid. In accord with the congressional decision to exclude net additions to policyholder reserves from the tax base, Section 809(d)(2) generally permits a deduction for increases in reserves during the taxable year attributable to the premiums included in income under Section 809(c)(1). When the various deductions are subtracted from the company's gross income from all sources, the resulting figure is the "gain from operations."

Since "gross amount of premiums" is an income item in the above computation, increases in that element will result in a higher figure for "gain from op-

erations" and a larger tax base. Conversely, since the "net increase in reserves" is a deduction item, increments to that statutory element will decrease the tax base.

B. THE FACTS OF THIS CASE AND THE PROCEEDINGS BELOW

1. Respondent is an Oklahoma stock corporation engaged in the business of issuing insurance. During 1958–1961, it qualified for preferential federal tax treatment as a "life insurance company," as that term is defined by Section 801(a) of the Internal Revenue Code of 1954. As a life insurance company, respondent was subject to supervision and audit by the Oklahoma Insurance Commissioner and by officials of the other states in which it did business (Pet. App. A 2a–3a; Pet. App. B 10a).[7]

During the years in question respondent received income consisting of life insurance premiums and the return on the investment of those premiums and previously received premiums (Exs. A, B, and D, A. 23–24, 25, 33–34, 36, 45–46, 48). The "gross premium" is the amount actually charged the insured, and con-

[7] In order to facilitate the work of making these examinations, the National Association of Insurance Commissioners (NAIC) has divided the United States into various zones. Under this zone system, an examination is made every three years of each company whose operations extend beyond any one zone. The examinations are performed by a team of auditors from the insurance department of the company's domiciliary state and from each of the other zones in which the company does business. Where a company operates in more than one state but not in more than one zone, the outside auditors are chosen from one or more states in the zone. See Wightman, *Life Insurance Statements and Accounts* 31–32 (1952 ed.).

sists of the "net valuation premium" and "loading." The "net valuation premium" is the amount computed under applicable actuarial tables (based upon mortality and interest rate assumptions) that the company must accumulate in order to pay all death claims.[8] The net valuation premium reflects the amount, together with assumed interest, that respondent was required under local law to add each year to its policy reserves. "Loading" is the amount added to the "net valuation premium" for agents' commissions and other acquisition costs, management and operating expenses, profits and dividends. (Pet. App. B 10a).

Respondent's policyholders pay their premiums annually on the anniversary dates of their policies, or in semi-annual, quarterly, or monthly installments. When the policyholders elect to pay their premiums other than annually, respondent imposes a supplemental charge in addition to the annual premium

[8] On a level premium plan, the aggregate amount of the net valuation premiums on a block of policies will more than cover the assumed death claims during the initial years the policies are in effect. In practical terms, the total amount of the net valuation premiums on these policies will be greater during these early years than the amount of death claims made against the company. Conversely, during the later years when the age of the policyholders has increased, death claims will exceed the aggregate amount of the net valuation portion of the level premiums currently paid by the policyholders. The excess amounts received by the company in the early years, together with interest at an assumed rate, will enable the company to meet death claims during the later years. See McGill, *Life Insurance* 32–36, 218–219 (Rev. ed. 1967); MacLean, *Life Insurance* 13–17, 111–116 (9th ed. 1962).

(Stip. par 6, A. 16).[9] "Deferred premiums" are those portions of the gross annual premiums that become due after the end of each calendar year but before the next anniversary date of the policy. Respondent's life insurance policies provide for a grace period of 31 days or longer for the payment of premiums during which the policy is fully effective. "Due and unpaid premiums" or "uncollected premiums" are premiums that are due and payable before the end of the calendar year but which have not been paid (Pet. App. B 11a; Stip. pars. 6–8, A. 16–17).

The insured has no obligation to pay the deferred or due and unpaid premiums on his policy. However, the insurer has no obligation to continue the insurance coverage beyond the period for which premiums have been paid. Thus, non-payment causes the policy to lapse (Pet. App. B 11a).

2. Respondent computed its reserves on its policies on the assumption that the annual premiums had been paid in full as of the anniversary date of each policy, whether or not this was in fact the case. Accordingly, on its annual financial statements required to be filed under state law, respondent increased its reserves by the amount of the net valuation portion of both its fully paid and its deferred and uncollected premiums (Stip. par. 11, A. 17; Pet. App. A 3a; Pet. App. B 11a). Respondent reflected the resulting figure on its

[9] The increased annual premium charged to the policyholders electing installment payment of their premium serves to compensate the company for the interest it would have otherwise earned had the premium been paid in full on the anniversary date.

annual statements as its "Aggregate reserve for life policies and contracts" (Exs. E, F, H, A. 61, 76, 91).[10] On its annual statements, respondent offset the inclusion of the net valuation portion of its deferred and uncollected premiums in reserves by also including such amounts on the assets side of the balance sheet (Pet. App. A 4a; Exs. E, F, H, A. 60, 75, 90).[11]

Respondent likewise computed its reserves for federal income tax purposes on the basis of the same assumption that the annual premiums on all of its outstanding policies had been paid in full as of the

[10] The annual statement forms filed by respondent with the state authorities are designed by the National Association of Insurance Commissioners (NAIC) to promote uniform reporting requirements in the various states. As a result, they are often referred to as the "NAIC annual statement" (see Pet. App. A 4a and n. 3). These annual reports contain summary statements of the company's total assets and the total of its various reserves and other liability accounts established as of the end of each year. Examination of the company's annual report enables the various insurance commissioners in the states in which the company conducts business to measure the company's solvency and to determine whether it has sufficient assets on hand to cover its potential obligations to its policyholders (see Exs. E, F, H, A. 60–61, 75–76, 90–91).

[11] Respondent made a similar adjustment on the "Summary of Operations" schedule of its annual financial statement designed to offset the inclusion in its reserves of its deferred and uncollected premiums. In order to compensate for the deduction of the increase in reserves attributable to the deferred and uncollected premiums, it included the gross amount of such premiums in income and further deducted the increase in loading on such premiums as an expense. The net effect of these offsetting entries was to eliminate the impact of deferred and uncollected premiums on respondent's summary of operations (Pet. App. A 5a; Exs. E, F, H, A. 62, 77, 92). See pp. 33–37, n. 26, *infra*.

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anniversary dates of the policies. It therefore included the net valuation portion of its "deferred and uncollected premiums"[12] in its "life insurance reserves" under Section 801(b)(1) of the Internal Revenue Code of 1954. Respondent accordingly added these amounts of its reserves in making the federal tax computations under Sections 805 and 809 of the Code (Pet. App. A 3a; Pet. App. B 11a).

Although respondent assumed that the annual premiums had been paid in full on the anniversary dates of all of the policies for purposes of computing its reserves on its 1958, 1959, and 1961 tax returns, it did not consistently apply that assumption in making the other required computations on its returns for those years. In computing its "assets" under Section 805(b)(4) on its 1958 return, respondent excluded the entire amount of deferred and uncollected premiums on the converse assumption that it did not receive the deferred and uncollected premiums during the taxable year. On its 1959 and 1961 returns, respondent computed its "assets" under Section 805(b)(4) in accordance with a different assumption. For those years, it included in its assets only the net valuation portion of its deferred and uncollected premiums (*i.e.*, exclusive of loading). Similarly, in its Section 809(c)(1) computation of "gross amount of premiums" on its 1958, 1959, and 1961 returns, respondent included only the net valuation

[12] For purposes of convenience, we employ the conventional term "deferred and uncollected premiums" to include deferred premiums, and due and unpaid or uncollected premiums.

portion of its deferred and uncollected premiums.[13] (Pet. App. A 5a–6a; Pet. App. B 11a–12a).

Respondent's exclusions of its deferred and uncollected premiums from the computations of its "assets" and "gross amount of premiums," coupled with its inclusion of such premiums in its "reserves," had the effect of reducing its "taxable investment income" and its "gain from operations," and thus its tax.

3. On audit, the Commissioner of Internal Revenue accepted respondent's computation of its reserves based upon the assumption that the annual premiums had been paid in full on all policies in force. However, pursuant to Treasury Regulations, Sections 1.805–5(a)(4) and 1.809–4(a), the Commissioner applied this assumption as well to the other tax computations; he accordingly concluded that respondent was required to include the gross amount of its deferred and uncollected premiums in "assets" and in "gross amount of premiums" under Sections 805(b)(4) and 809(c)(1), respectively (Pet. App. B 12a). The Commissioner thereby determined deficiencies against respondent for 1958, 1959, and 1961, of $25,974.93, $90,647.02 and $34,986.04, respectively (Pet. App. A 1a).[14]

[13] The courts below characterized respondent as having claimed "deductions for the increases in loading" in computing its gains from operations under Section 809 (Pet. App. A 6a; Pet. App. B 12a). In fact, respondent actually included the gross amount of deferred and uncollected premiums in its "gross amount of premiums" but claimed a deduction for the loading portion of these premiums. The net effect was the same as if respondent included only the net valuation portion of its deferred and uncollected premiums in its "gross amount of premiums."

[14] The Commissioner's adjustments did not result in a deficiency for 1960 (A. 103).

The Commissioner also imposed a five percent penalty under

On the authority of its unanimous reviewed decision in *Bankers Union Life Insurance Co.* v. *Commissioner*, 62 T.C. 661, the Tax Court upheld the Commissioner's determination that the assumption that the annual premiums had been paid in full on all policies had to be consistently applied to all of the tax computations. It therefore held that respondent was required to include its deferred and uncollected premiums in "assets" under Section 805(b)(4) and in "gross amount of premiums" under Section 809(c)(1), without offset or deduction with respect to the loading portion of these premiums (Pet. App. A 7a–8a).

A divided court of appeals reversed (Pet. App. B 9a–23a). The court held that respondent was not required to include any portion of its deferred and uncollected premiums in "assets" and "gross amount of premiums," even though it included the net valuation portion of these premiums in its reserves for purposes of the Sections 805 and 809 computations. In so holding, the court accorded respondent the benefit of more favorable tax treatment than it claimed on its 1959 and 1961 returns, when it included the net valuation portions of the deferred and uncollected premiums in "assets" and in "gross amount of premiums" as well as in its "reserves" (Pet. App. B 11a–12a).

While the court acknowledged that four other courts of appeals had upheld the Commissioner's position

Section 6653(a) of the Code because of respondent's negligence or intentional disregard of the Regulations (Pet. App. A 1a; A. 103). The parties have stipulated that the five percent penalty would apply to any deficiency upheld in the ultimate disposition of the case (Stip. par. 22, A. 19).

(Pet. App. B 13a–14a), it stated that those decisions "are predicated on a fiction" (Pet. App. B 16a). It reasoned that respondent "has no legal, enforceable right to collect any unpaid premiums * * *" (Pet. App. B 18a), and that "it is * * * obvious that unpaid premiums are not 'assets used by a company in carrying on a trade or business' and that they cannot have any 'viable' asset basis until collected" (*ibid.*). The court likewise concluded that the "gross amount of premiums" under Section 809(c)(1) "cannot extend to unpaid premiums in which a taxpayer has no legally enforceable right" (Pet. App. B 21a). In so holding, the court invalidated the Treasury Regulations that mandated the Commissioner's consistent treatment of deferred and uncollected premiums in the computation of "reserves," "assets," and "gross amount of premiums" (Pet. App. B 16a–19a).

After observing that the issue "has been considered by four other Circuits, and in each instance * * * [those courts had] reached a conclusion contrary to the result reached by the majority * * *," the dissenting judge stated that he was "persuaded that the result reached by the Fourth, Fifth, Sixth, and Seventh Circuits is the proper one" (Pet. App. B 22a).[14a]

[14a] *Franklin Life Insurance Co.* v. *United States*, 399 F. 2d 757 (C.A. 7), certiorari denied, 393 U.S. 1118; *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F. 2d 842 (C.A. 4) certiorari denied, 396 U.S. 828; *Western National Life Insurance Co. of Texas* v. *Commissioner*, 432 F. 2d 298 (C.A. 5); *Western and Southern Life Insurance Co.* v. *Commissioner*, 460 F. 2d 8 (C.A. 6), certiorari denied, 409 U.S. 1068.

SUMMARY OF ARGUMENT

I

The Life Insurance Company Income Tax Act of 1959 provides a three-phase procedure for the taxation of life insurance companies. The primary categories of income subject to tax are "taxable investment income" and "gain from operations." Pursuant to the statute, the computations of both "taxable investment income" and "gain from operations" provide a mechanism for excluding from the total tax base those portions of a company's investment and premium income that must be held to meet its policyholder obligations.

The three principal elements that enter into the federal income tax computations of a life insurance company are: (1) "reserves," (2) "assets," and (3) "gross amount of premiums." The computation of the tax-free portion of investment income generally involves multiplying the company's total investment income by the fraction $\frac{\text{Reserves}}{\text{Assets}}$. The computation of "gain from operations" is a more traditional net income calculation, with "gross amount of premiums" included as an income item and "reserves" subtracted as a deductible expense. Thus, all other elements of the tax computation remaining constant, as a life insurance company's "reserves" increase, its tax liability will correspondingly decrease. Conversely, as the company's "assets" and "gross amount of premiums" increase, its tax liability will also increase.

The question presented in this case involves the extent to which "deferred and uncollected premiums"

are taken into account in determining a life insurance company's "reserves," "assets," and "gross amount of premiums." Deferred and uncollected premiums are the sum of: (1) those portions of the gross annual premiums that become due after the end of the calendar year but before the next anniversary dates of the policies because of the policyholders' election to pay their annual premium in installments; and (2) the premiums that have become due and payable before the end of the year but that have not been paid. In both instances, it is undisputed that the company does not have deferred and uncollected premiums on hand as of the end of the calendar year and has no legal right to compel their payment. In the event of nonpayment, the policy lapses.

Following the longstanding accounting convention of the life insurance industry, respondent computed its year-end reserves for both financial reporting and federal tax purposes on the assumption that the full annual premium had been paid as of the anniversary dates of all of its policies in force. Insurance reserves arise upon the acceptance of a risk and the payment of premiums. Thus, respondent's premium receipt assumption resulted in an overstatement of its reserves by the net valuation portion of the deferred and uncollected premiums because it had not in fact received the full annual premiums and did not in fact have any liability to the policyholders with respect to these unpaid premiums. Respondent's increase in reserves based upon its assumption of full premium payment had the effect of decreasing its tax liability.

However, in computing its "assets" and "gross amount of premiums"—statutory elements that increase a life insurance company's tax liability—respondent abandoned the full premium payment assumption upon which it calculated its reserves. For those purposes, it included none of the deferred and uncollected premiums in "assets" for 1958, and only the lesser "net valuation" portion of those premiums in "assets" for 1959 and 1961 and "gross amount of premiums" for all those years.

Four courts of appeals have correctly held that a life insurance company cannot first treat its deferred and uncollected premiums as having been paid during the taxable year for purposes of increasing its "reserves" and thereby reducing its tax base; and then turn around and claim that it has not received the identical premiums for purposes of the "assets" and "gross amount of premiums" computations. The decision below improperly treats the deferred and uncollected premiums as both having been paid and having not been paid during the taxable year.

The integrity of the federal tax formulae, which rest upon the proportionate relationship between "reserves" and "assets," demands that all of its statutory elements be computed in accordance with a consistent set of assumptions. As the Fourth Circuit succinctly stated in *Jefferson Standard Life Insurance Co.* v. *United States,* 408 F. 2d 842, 856, certiorari denied, 396 U.S. 828: "Symmetry would require * * * that both sides of the equation by which taxable income is determined be treated alike. Thus, if taxpayer treats its reserve liabilities for tax purposes with a full

year's net valuation * * * it should be required to include gross annual premiums * * *" in its assets and premium income.

II

The pertinent Treasury Regulations (Sections 1.805–5(a)(4)(ii) and 1.809–4(a)(1)), which the court of appeals erroneously invalidated, likewise recognize the insurance industry's convention of overstating reserves by assuming full annual premium payment. They accordingly provide that a company must include the gross amount of deferred and uncollected premiums in "assets" and "gross amount of premiums" as long as it computes its reserves on the assumption that these premiums have been paid. If a life insurance company asumes that the deferred and uncollected premiums on all of its policies have been paid as of their anniversary dates and increases its reserves by the net valuation of such premiums, that assumption necessarily stands on the hypothesis that the company has received the full amount of those premiums.

Hence, our primary position is that gross deferred and uncollected premiums must be included in "assets" and "gross amount of premiums" if the net valuation portion of such premiums is to be included in "reserves." However, if the Court disagrees with our submission that the full amount of deferred and uncollected premiums be included in "assets" and "gross amount of premiums," the proper disposition of this case is to exclude such premiums altogether from the calculation of both (1) "reserves" and (2) "assets" and "gross amount of premiums," in accordance with Treasury Regulations, Section 1.801–4(f).

ARGUMENT

A LIFE INSURANCE COMPANY THAT INCLUDES THE NET VALUATION PORTION OF ITS DEFERRED AND UNCOLLECTED PREMIUMS IN ITS "RESERVES" FOR FEDERAL TAX PURPOSES ON THE ASSUMPTION THAT THE GROSS ANNUAL PREMIUMS ON ITS POLICIES HAVE BEEN PAID IN FULL ON THE POLICY ANNIVERSARY DATES MUST CONSISTENTLY APPLY THAT ASSUMPTION FOR ALL OF ITS TAX COMPUTATIONS AND INCLUDE THE FULL AMOUNT OF ITS DEFERRED AND UNCOLLECTED PREMIUMS IN ITS "ASSETS" AND "GROSS AMOUNT OF PREMIUMS"

A. INTRODUCTION

1. This case presents a question of major fiscal importance affecting the federal income taxation of every life insurance company. Life insurance companies generally permit their policyholders to pay their annual premium either in full on the anniversary date of the policy or in installments on a monthly, quarterly, or semi-annual basis. In the event the policyholder elects to pay the annual premium in installments, those portions of the gross annual premiums that become due after the end of the calendar year but before the next anniversary date of the policy are known as "deferred premiums." "Due and unpaid premiums" or "uncollected premiums" are premiums that are due and payable before the end of the calendar year but which have not been paid. These two types of premiums—described in the aggregate by the insurance literature as "deferred and uncollected premiums"—are a substantial element in the business of all life insurance companies. The issue here involves the proper federal

tax treatment of these deferred and uncollected premiums.

A life insurance company receives its income from the receipt of premiums and the investment of its assets. As we have pointed out *supra*, pp. 3–8, the Life Insurance Company Income Tax Act of 1959, set forth in Sections 801–820 of the Internal Revenue Code of 1954, provides a three-phase procedure for the taxation of both types of life insurance company income. The Act represented "a comprehensive overhaul of the laws relating to the taxation of life insurance companies." *United States* v. *Atlas Life Ins. Co., supra,* 381 U.S. at 235.

The basic thrust of the statute is to permit a life insurance company to exclude from its tax base that portion of its premium and investment income that is necessary to cover its reserve liabilities—the amount computed to be sufficient under the statute to pay future death claims. Thus, the cornerstone of the statutory system is the reserve which, as we shall explain *infra,* pp. 29–33, arises from the policyholders' payment of premiums.

Under the 1959 Act, a life insurance company is subject to tax on its "taxable investment income" plus one-half of the amount by which its total "gain from operations" exceeds its "taxable investment income." To the extent that it recognizes that amounts computed by life insurance companies as necessary to cover their reserves should be free of tax, the 1959 Act represents a continuation of the longstanding congressional policy to treat increments to the reserves

as representing amounts belonging to the policyholders rather than to the company. See *A Preliminary Statement of the Facts and Issues with Respect to the Federal Taxation of Life Insurance Companies,* Subcommittee on the Taxation of Life Insurance Companies, House Committee on Ways and Means, p. 21 (November 1954).

While Congress has always recognized that amounts that life insurance companies set aside to pay future death claims should be excluded from their tax base, it has employed various approaches in determining the measure of this tax exclusion. Thus, from 1913 to 1920, life insurance companies were taxed like all other corporations on their entire investment and premium income but were allowed a deduction for the "net addition required by law to be made within the taxable year to reserve funds."[15] In 1921, however, Congress abandoned this so-called "total income" approach and determined that life insurance companies would be taxed only on their "free investment income" not needed to cover policyholder obligations. During this period, premium income was totally excluded from the tax base. See Revenue Act of 1921, c. 136, Sections 242–247, 42 Stat. 227, 261–264. The concept that a tax should be levied on net investment income after an allowance to meet obligations to

[15] See, *e.g.*, Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, 172, Sec. II(G)(b); Revenue Act of 1916, c. 463, 39 Stat. 756, 768, Sec. 12(a) Second; Revenue Act of 1918, c. 18, 40 Stat. 1057, 1079, Section 234(a)(10). See also Treasury Regulations No. 33 (Rev.), Art. 239, pars. 673–674 (1918); Treasury Regulations No. 45 (1920 ed.), Arts. 548, 549, 569.

policyholders was carried forward in subsequent acts and is also included in the broad revision of the 1959 Act.[16]

The 1959 Act introduced two fundamental changes in the taxation of life insurance companies. While it retained the concept of excluding from tax that portion of investment income necessary to cover policyholder reserves, the Act abandoned the assumed

[16] During the period 1921–1959, various formulae were used in computing the amount of the reserve exclusion. See *e.g.*, Revenue Act of 1924, c. 234, 43 Stat. 253, 289, Sec. 245(a); Revenue Act of 1926, c. 27, 44 Stat. 9, 47, Sec. 245(a); Revenue Act of 1928, c. 852, 45 Stat. 791, 842, Sec. 203(a); Revenue Act of 1932, c. 209, 47 Stat. 169, 224, Sec. 203(a); Revenue Act of 1934, c. 277, 48 Stat. 680, 732, Sec. 203(a); Revenue Act of 1936, c. 690, 49 Stat. 1648, 1710, Sec. 203(a); Revenue Act of 1938, c. 289, 52 Stat. 447, 523, Sec. 203(a); Internal Revenue Code of 1939, Sec. 203(a) (26 U.S.C. 203(a) (1952 ed.)).

Some of the formulae employed an industry-wide assumed rate of interest and resulted in the complete erosion of the tax base of life insurance companies. Thus, in 1947 and 1948, no life insurance company paid any federal taxes on profits from its life insurance business. See *A Preliminary Statement of the Facts and Issues with Respect to the Federal Taxation of Life Insurance Companies*, *supra*, at 16–17; Denney, Rua & Schoen, *Federal Income Taxation of Insurance Companies*, pp. 1.1–1.2 (2d ed. 1966). Between 1949 and 1958, Congress accordingly enacted a series of "stopgap" measures to provide a short-term remedy. See *Report on the Taxation of Life Insurance Companies*, Subcommittee on Internal Revenue Taxation, House Committee on Ways and Means, pp. 2–3 (December 31, 1958). See, *e.g.*, Revenue Act of 1950, c. 994, 64 Stat. 906, 961, Sec. 401(a); Revenue Act of 1951, c. 521, 65 Stat. 452, 507, Sec. 336; Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36, 41, Sec. 804. Some of these "stopgap" measures were designed to impose a tax, at ordinary corporate rates, on a small fixed percentage of investment income. Others imposed a tax, at greatly reduced rates, on all investment income.

or industry-wide average rate of interest approach that had been employed in the allocation formulae under the prior law. Instead, the 1959 Act prescribed a method of allocating investment income based upon the company's actual earnings experience. See S. Rep. No. 291, 86th Cong., 1st Sess. 5 (1959); 105 Cong. Rec. 8428–8429 (1959) (remarks of Senator Curtis). The Act also expanded the companies' tax base to include underwriting gains, *i.e.*, the amount by which premiums exceeded the actual expenses and policy obligations. See H.R. Rep. No. 34, 86th Cong., 1st Sess. 2–3, 12–13 (1959); S. Rep. No. 291, *supra*, at 6–7. Specifically, the 1959 Act taxes one-half of the company's underwriting gains on a current basis and generally postpones taxation of the remaining half until such gains are distributed to shareholders. Thus, while the computations are more detailed, the basic approach of the 1959 Act was to return in part to the pre-1921 "total income" approach under which insurance companies were immediately taxed on their entire net investment and underwriting (premium) income.[17]

2. Three principal elements that enter into the fed-

[17] Accordingly, apart from the 1959 Act's postponement of tax on one-half of the underwriting gains, the approach of the 1959 Act and the pre-1921 law is essentially the same.

The pre-1921 law has been described as follows: "Although premiums were included as gross income, such part of each premium as was credited to the policyholder by way of a credit to a reserve was deducted; and * * * although all investment income was includible, that part which was, in effect, credited to policyholders as interest on the reserves was deducted." *A Preliminary Statement of the Facts and Issues with Respect to the Federal Taxation of Life Insurance Companies*, *supra*, at p. 14.

eral income tax computations of a life insurance company under the 1959 Act are: (1) "reserves," (2) "assets," and (3) "gross amount of premiums." As a life insurance company's "reserves" increase relative to its assets and premiums, its tax liability will correspondingly decrease. Conversely, as the company's "assets" and "gross amount of premiums" increase relative to its reserves, its tax liability will increase (see pp. 6–7, *supra*). These three elements, however, are not independent variables but are functionally interrelated. As premiums are paid, the company's "assets" and "gross amounts of premiums" necessarily increase and its "reserves" likewise increase (see pp. 30–31, *infra*).

The question here involves the extent to which deferred and uncollected premiums are taken into account for federal tax purposes in determining a life insurance company's "reserves," "assets," and "gross amount of premiums." It is undisputed that the company does not actually have such deferred and uncollected premiums on hand at the end of its taxable year and does not have any legal right to compel their payment from the insured.[18] Nonpayment relieves the company of its liability to pay death benefits and causes the policy to lapse.

Nevertheless, in computing its "reserves" on its tax returns for all three taxable years at issue, respondent made the traditional assumption of the life insurance

[18] Upon the lapse of the policy, state law requires the company to credit the cash surrender value to the account of the policyholder. The cash surrender value is calculated on the basis of premiums actually paid to the date of the lapse. See, *e.g.*, 36 Okla. Stat. Ann., Sec. 4029H (1958).

industry that the full annual premium had been paid on all its outstanding policies on their anniversary dates. It thereby increased its "reserves" for tax purposes by the "net valuation" portion of all annual premiums, including the deferred and uncollected premiums. Because increases in reserves reduce a life insurance company's "taxable investment income" and "gain from operations," respondent's increase in reserves based upon its assumption of full premium payment had the effect of decreasing its tax liability.

However, in computing its "assets" and "gross amount of premiums"—the related statutory elements that increase a life insurance company's tax liability—respondent did an about-face and abandoned the assumption upon which it calculated its reserves, *viz.*, that it received the full annual premium on all of its policies. For those purposes, it included no part of the deferred and uncollected premiums in "assets" for 1958 and only the "net valuation" portion of those premiums for 1959 and 1961. For 1958, 1959, and 1961, respondent included only the net valuation portion of its deferred and uncollected premiums in "gross amount of premiums" (see p. 13, n. 13, *supra*). Respondent's exclusion in 1958 of the full amount of deferred and uncollected premiums from "assets," its partial exclusion of such premiums from "gross amount of premiums" for that year, and its partial exclusion of such premiums from both "assets" and "gross amount of premiums" in 1959 and 1961 reduced respondent's tax liability for those years.

Our submission is that a life insurance company must adhere to a consistent set of assumptions in computing its federal tax liability. It cannot first treat its deferred and uncollected premiums as having been paid during the taxable year for purposes of increasing "reserves" and thereby reduce its tax base, and then turn around and assert that it has not received those premiums for purposes of computing its "assets" and "gross amount of premiums." The fundamental error of the court of appeals is that it simultaneously assumed that the deferred and uncollected premiums were both paid and not paid during the taxable year. Deferred and uncollected premiums are deemed either to have been paid for purposes of all of the prescribed computations or not to have been paid for any of the computations.

The pertinent Treasury Regulations, which have been upheld by four courts of appeals, rest upon this same requirement of consistency. Sections 1.805–5(a)(4)(ii) and 1.809–4(a) of the Regulations, Appendix, *infra,* pp. 20A–23A, respectively provide that a life insurance company must include its deferred and uncollected premiums in its "assets" and "gross amount of premiums" under Sections 805(a)(4) and 809(c)(1). However, in the event that it is determined that deferred and uncollected premiums are not properly includable in "assets" and "gross amount of premiums," Section 1.801–4(f) of the Regulations, Appendix, *infra,* pp. 19A–20A, alternatively requires the exclusion of such premiums in the computation of "reserves."

3. Viewed in the larger context, these Treasury Regulations are in accord with the "long-established

congressional policy that a taxpayer generally cannot compute income taxes by reporting annual income on a cash basis and deductions on an accrual basis" (*Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501). As this Court there recognized (*ibid.*), "[s]uch a practice has been uniformly held inadmissible because it results in a distorted picture which makes a tax return fail truly to reflect net income." Thus, this Court has consistently rejected such hybrid methods of accounting, in which the taxpayer chooses the best of both worlds. See *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 96–99; *United States* v. *Catto*, 384 U.S. 102, 116–117. See also *W. L. Moody Cotton Co.* v. *Commissioner*, 143 F. 2d 712, 714 (C.A. 5).

Moreover, in *Mass. Mutual Life Ins. Co.* v. *United States*, 288 U.S. 269, the Court unanimously held that this principle of uniformity of accounting assumptions applied to the taxation of life insurance companies. There, the Court ruled that a life insurance company that filed its returns on the cash basis method of accounting could not claim a current deduction for unpaid interest owed to policyholders. In so holding, the Court stated—"It is settled beyond cavil that taxpayers other than insurance companies may not accrue receipts and treat expenditures on a cash basis, or vice versa. Nor may they accrue a portion of income and deal with the remainder on a cash basis, nor take deductions partly on one and partly on the other basis. Congress we think did not intend to make an exception of insurance companies" (*id.* at 273–274). See also *Continental Life Insurance Co.* v. *Commissioner*, 5 B.T.A. 407, 412.

The rule of uniformity and consistency announced in *Mass. Mutual Life Ins. Co.* applies with equal force to the deferred and uncollected premiums at issue in this case. Respondent cannot take those premiums into account in its "reserves" when it suits its purpose of reducing its tax base but turn its back on them when their inclusion in "assets" and "gross amount of premiums" would increase its tax liability. Simply stated, our position is that such premiums must be consistently deemed to have been paid for all purposes under the statute or not to have been paid for any purpose.

The concept of a life insurance reserve is fundamental to an understanding of the taxation of life insurance company income. Before discussing the impact of deferred and uncollected premiums on the federal tax computations, we believe it would be helpful to describe the nature and function of that reserve.

B. A LIFE INSURANCE RESERVE ARISES UPON THE COMPANY'S ASSUMPTION OF THE RISK AND THE POLICYHOLDER'S PAYMENT OF PREMIUMS

1. "Historically and commonly insurance involves risk-shifting and risk-distributing" (*Helvering* v. *LeGierse*, 312 U.S. 531, 539). The consideration paid by an insured for the assumption of the risk by an insurance company is the premium. The amount of the premium is calculated on the assumption that the premiums received by the company will be invested and earn interest which, when added to the accumulated premiums, will be sufficient to pay the policyholders' death claims as they arise. As the standard texts on life insurance make clear, a life insurance reserve is made up of the sum of net valuation premiums paid

to date, plus interest at the assumed rate, minus assumed death claims. See, *e.g.*, MacLean, *Life Insurance*, 90–116 (9th ed. 1962).[19]

In setting a life insurance premium, the company first chooses a mortality table and assumes an interest rate for the investment of the premiums. With these elements established, the net valuation premium can be calculated. Net valuation premiums, plus interest at the assumed rate, will be adequate to pay all claims on the assumption that deaths will occur according to the mortality table. The gross premium that is charged the policyholder is determined by adding to the net valuation premium an amount known in the aggregate as "loading," which covers the company's estimated expenses for agents' commissions and other overhead and profits.

The decisions of this Court likewise define a life insurance reserve for federal tax purposes as derived from the premiums paid by the policyholder. See, *e.g.*, *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109, 115, 119; *New York Life Ins. Co.* v. *Bowers*, 283 U.S. 242, 244; *Helvering* v. *Inter-Mountain Life Ins. Co.*, 294 U.S. 686, 690. Accord: *Williams* v. *Union Central Life Insurance Co.*, 291 U.S. 170, 177. As the Court more recently observed in *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 247, "[t]he receipt of premiums necessarily entails the creation of reserves and additions to reserves from investment income. Thus the insurance company is not only permitted to in-

[19] While other texts are cast in somewhat more technical terms, they are to the same effect on this basic point. See, *e.g.*, Huebner and Black, *Life Insurance* 277–279 (9th ed. 1976); Magee, *Life Insurance* 559–562 (3d ed. 1958); McGill, *Life Insurance* 182–185, 218–223 (Rev. ed. 1967).

vest, but it *must* invest; and it *must* return to the reserve a large portion of its investment income" (emphasis in original).[20]

There is accordingly a direct relationship between the payment of premiums by the policyholder and the company's establishment of reserves. Without the payment of premiums by the policyholder in exchange for the company's assumption of the risk, there is no occasion for the company to establish a reserve. As a leading text has succinctly stated, the reserve is "built up out of past premium payments and interest to meet * * * [future policy obligations] determined mathematically." Magee, *Life Insurance* 560 (3d ed. 1958).[21]

[20] While the reserves for most forms of life insurance are computed on the assumption of investment of the net valuation premiums, reserves for short-term casualty insurance are computed solely on the basis of the pro rata unearned gross premium without any investment element. See Treasury Regulations, Section 1.801–3(e). This latter type of reserve is involved in *United States* v. *Consumer Life Insurance Co.*, No. 75–1221; *First Railroad & Banking Co. of Georgia* v. *United States*, No. 75–1260; and *United States* v. *Penn Security Life Insurance Co.*, No. 75–1285, argued December 6, 1976.

[21] In stating that there is a direct relationship between the payment of premiums and the establishment of policy reserves, we assume that the premium charged by the company is sufficient to meet state statutory minimum reserve requirements. However, if competitive conditions cause the company to assume a risk and charge a gross premium that is less than the net valuation premium on the expectation that it will meet its policyholder obligations from sources other than premiums, the company is required to establish a supplemental reserve known as a "deficiency reserve." This deficiency reserve reflects the excess of the present value of required future net premiums over the present value of future actual premiums. See Huebner and Black, *Life Insurance* 289 (9th ed. 1976). However, Section 801(b)(4) of the Code excludes such deficiency reserves from the definition of "life insurance reserves."

Life insurance reserves are sometimes described as "funds" held for the benefit of policyholders. However, a life insurance company does not actually segregate or set aside any portion of its assets in a particular reserve fund. All of an insurance company's assets are subject to policy claims when they mature. Thus, the reserve is not an asset or a fund of any kind. It is simply a calculation of projected liabilities established as a measuring device in order to determine the assets that the company must maintain in order to meet its future commitments under the policies it has issued. Greider and Beadles, *Principles of Life Insurance* 68–69 (Rev. ed. 1972).

While the reserve is "represented by assets which the company invests * * * [it] is, in fact, a company liability." Magee, *supra*, at 560. If the net assets of the company fall below the reserves so computed, the company is deemed insolvent and may no longer engage in business.

Finally, a life insurance reserve may be defined either prospectively or retrospectively, yielding the same mathematical result. McGill, *Life Insurance* 219 (Rev. ed. 1967); Magee, *supra,* p. 560. When a policy is issued, the discounted or present value of the future benefits is exactly equal to the present value of all of the net valuation premiums to be paid. However, at any given time after the date of issue, the present value of the benefits to be paid under the policy will increase because the date of payment of the policy benefits has drawn closer. Viewed prospectively, the reserve is equal to the difference between the present value of the benefits and the present value of the future net premiums.[22] Viewed retrospectively, the reserve is equal to the amount of net valuation premiums, plus interest at the assumed rate, less assumed death claims. See MacLean, *Life Insurance* 111–115 (9th ed. 1962); Huebner and Black, *Life Insurance* 278–285 (9th ed. 1976). Thus, at any give time, the amount of a company's reserves can be expressed either in terms of the premiums it already has received or the premiums it expects to receive.

2. In view of the direct relationship between the policyholders' payment of premiums and the company's establishment of reserves, the treatment of deferred and uncollected premiums would seem to be a relatively simple matter. The policyholders have not paid such premiums and are not subject to any legal obligation to pay them. Moreover, the company has not assumed any liability for periods of unpaid coverage.[23] In the absence of payment, the policy lapses. Likewise, until premiums are paid, the com-

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[22] State statutes generally employ the prospective definition of a reserve. Thus, the Oklahoma Standard Valuation Law (36 Okla. Stat. Ann., Sec. 1510(E)(2) (1958)), to which respondent was subject, states—

"* * * Reserves for the life insurance and endowment benefits of policies providing for a uniform amount of insurance and requiring the payment of uniform premiums shall be the excess, if any, of the present value, at the date of valuation, of such future guaranteed benefits provided for by such policies, over the then present value of any future modified net premiums therefor."

[23] If a policyholder dies during the 31-day grace period when the policy is still in force, the state statutes permit the company to deduct the uncollected premium from the policy proceeds. See, *e.g.*, 36 Okla. Stat. Ann., Sec. 4003 (1958). This withholding procedure enables the company to recover the unpaid premium.

pany will not be required to set aside any portion of such premiums for the payment of future benefits.

Logic would appear to dictate that deferred and uncollected premiums not be taken into account for any of the federal tax computations of "reserves," "assets," or "gross amount of premiums." But the inclusion of deferred and uncollected premiums for purposes of all of the computations of "reserves," "assets," and "gross amount of premiums," as provided by the primary position of the Treasury Regulations, is grounded upon its own internal logic. Moreover, it is traceable to the historical practice of the life insurance industry to include the net valuation portion of such premiums for financial reporting purposes when computing its reserves.

Pursuant to the practice adopted by the First Session of the National Insurance Convention in 1871,[24] life insurance companies have computed their aggregate reserves as stated on their financial statements on the assumption that the full annual premiums on all outstanding policies have been paid on the policy anniversary dates. See *Official Report of the Proceedings of the National Insurance Convention of the United States* 68–70 (1871). The 1871 Report acknowl-

[24] The National Insurance Convention is the predecessor organization of the National Association of Insurance Commissioners (NAIC). It is "a purely voluntary association without any legal status or authority. Because, however, every State Insurance Commissioner has recognized its value and has, at all times, given to it unstinted cooperation, the Association has, to a broad extent, been able to secure much uniformity in the regulation of insurance matters throughout the United States." Wightman, *Life Insurance Statements and Accounts* 27 (1952 ed.).

edged that this assumption results in an overstatement of the company's reserves to the extent of the net valuation portion of the deferred and uncollected premiums. The Report submitted to the Convention therefore recognized that "it is very clear that * * * [the company] should have a corresponding credit given for the portion of the premium remaining unpaid" (*id.* at 69).

The Report first considered the practicability of "taking the whole item of 'deferred premiums' out of the list of 'assets' and correspondingly reducing the policy liability [*i.e.*, the reserve]" (*ibid.*). After concluding that the actuarial work involved in such a method would be burdensome, the Convention's Report prescribed "a substitute bringing us to substantially the same result," *viz.*, creating a "deferred premiums" asset "to the same extent as that liability [reserve] has been thereby increased, but no farther" (*ibid.*). However, the Report further explained that the proper amount of the credit to the asset account was not the entire amount of the deferred premium, but the deferred premium offset by the loading element, *i.e.*, the net valuation portion of the premium.[25]

The Report made it clear that the "deferred premium" asset had no intrinsic value as an asset; it

[25] The Insurance Convention adopted the assumption of full premium payment in order to avoid the burdensome actuarial work involved in computing the total reserves on a policy-by-policy basis by taking into account only premiums actually paid. Since the annual premiums on most policies were paid in full at the time, it was easier to adopt the assumption of full premium payment for all policies and to correct the resulting overstatement of reserves by the creation of an offsetting asset.

was included on the company's statement "for the sole purpose of cancelling an equal amount of the liability [reserve] with which the company is charged in the policy valuation [reserve computation]" (*id.* at 70). By creating a "quasi-asset" (*ibid.*) consisting of the net deferred and uncollected premiums to offset the overstatement of the reserves, the solution devised by the Convention balanced the company's annual statement. It further r[illegible] the company of the necessity of covering the o[illegible]ent of its reserves with actual assets, and [illegible] avoided impairment of the comany's surplus.

This financial reporting method for deferred and uncollected premiums developed more than a century ago by the National Insurance Convention is still employed today. Thus, on its annual statements, respondent computed its reserves on the majority of its policies on the assumption that the annual premiums were paid in full as of the policies' anniversary dates, even though this was not in fact the case (Pet. App. B 11a). (See also Pet. App. A 3a; Stip. par. 11, A 17.) Respondent offset the resulting overstatement of its reserves by entering the same amount (th[illegible] net valuation portion of the deferred and unco[illegible]ected premiums) in an asset account entitled "Life insurance premiums and annuity considerations deferred and uncollected" (Exs. E, F, H, A. 60, 75, 90).[26]

[26] Respondent made a similar adjustment on the "Summary of Operations" part of its annual financial statements designed to offset the overstatement of its reserves by the net valuation portion of its deferred and uncollected premiums. It included the gross deferred and uncollected premiums as part of its "Premiums and Annuity Considerations" and offset the remaining loading element by a deduction for "Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums" (see Pet. App. A 5a; Exs. E, F, H, A. 62, 77, 92).

But this accounting treatment is nothing more than a device to permit the assumption of full premium payment and the concomitant overstatement of reserves without distorting the picture of the company's solvency projected by the annual financial report. As one authoritative insurance text states, "In order to offset the overstatement of the aggregate reserves because of the failure of the assumption upon which they were computed to conform with the actual facts in all cases, a company was and is still permitted to include in its assets the entire amount of all * * * [deferred and uncollected] net premiums computed as of the year-end. Obviously this is merely a corrective adjustment of the assets to offset an overstatement of the liabilities." Wightman, *Life Insurance Statements and Accounts* 43–44 (1952 ed.).[27] See also *id.* at 155, 545; MacLean, *supra,* at 318–319; Ernst & Ernst, *GAAP* [Generally Accepted Accounting Principles]-*Stock Life Companies* 449–450 (1974); Beardsley, *Life Company Annual Statement Handbook* III–15 (1962).

3. The history of the life insurance industry's financial reporting treatment of deferred and uncollected

[27] Wightman characterizes the device of overstating reserves and assets in equal amounts as "unnecessarily clumsy." In his view, a much simpler method would be to deduct the overstatement of the reserves from the aggregate reserves before entering the reserve liability on the annual statement. See Wightman, *supra,* at 45–46.

premiums shows that the inclusion of the net valuation portion of deferred and uncollected premiums in reserves does not reflect an actual liability of the company but is in fact an overstatement that must be offset by an artificial asset. As a matter of absolute logic deferred and uncollected premiums should therefore be excluded altogether from the federal tax computations of "assets," "gross amount of premiums," and "reserves." That is the alternative approach prescribed by Section 1.801–4(f) of the Treasury Regulations.

However, the primary portion of the Regulations does not require total exclusion of the deferred and uncollected premiums. Instead, it prescribes the inclusion of the gross amount of deferred and uncollected premiums in "assets" and "gross amount of premiums." In so providing, Sections 1.805–5(a)(4) and 1.809–4(a)(1) of the Regulations accept the industry's convention of overstating the reserves by the amount of the net valuation portion of the deferred and uncollected premiums. But since that overstatement rests upon the assumption that all premiums are paid as of the anniversary dates of the policies in force, the full amount of the deferred and uncollected premiums must likewise be included in "assets" and "gross amount of premiums" by virtue of the selfsame assumption. We turn now to a detailed analysis of the impact of deferred and uncollected premiums upon the prescribed federal tax computations of "assets" and "gross amount of premiums."

C. A LIFE INSURANCE COMPANY THAT INCREASES ITS "RESERVES" BY THE NET VALUATION PORTION OF ITS DEFERRED AND UNCOLLECTED PREMIUMS MUST INCLUDE THE GROSS AMOUNT OF SUCH PREMIUMS IN ITS COMPUTATION OF "ASSETS" UNDER SECTION 805(b)(4)

1. As we have described *supra,* pp. 5–7, the Phase I computation of a life insurance company's taxable investment income involves a division of the company's investment income into two parts—the tax-free policyholders' share and the taxable company's share. See *United States* v. *Atlas Life Ins. Co., supra,* 381 U.S. at 236–237. The Act accomplishes this allocation by dividing the company's "investment yield" (Section 804(c)) by its total "assets" (Section 805(b)(4)) to derive the company's actual earnings rate. This rate, after adjustment,[28] is then multiplied by the company's adjusted life insurance reserves.[29] The resulting figure is the "policy and other contract liability requirements" (Sections 804(a)(1) and 805(a)), the term employed by the Act to describe the total amount of

[28] Section 805(b) provides that adjusted earnings rate (called the "adjusted reserves rate") is the lower of the current earnings rate or the average of the current earnings rate and those for the preceding four years (see p. 5, n. 5, *supra*).

[29] Pursuant to Section 805(c)(1), the reserves are adjusted under the "Menge Formula," named after its principal industry proponent. This formula provides that the company's reserves will be reduced 10 percent for each percentage point that its "adjusted reserves rate" exceeds the assumed rate of interest used by the company in setting up and calculating its reserve. Conversely, if the company's assumed rate of interest exceeds its adjusted earnings rate, the company's reserve will be increased 10 percent for each percentage point of the excess. See H.R. Rep. No. 34, *supra,* at 11; S. Rep. No. 291, *supra,* at 15–16. See also McGill, *supra,* at 915–916.

investment income that is excluded from the company's tax base.[30]

The statutory Phase I computation can be expressed by the following formulae:

$$(1)\quad \frac{\text{Investment Yield}}{\text{Assets}} = \text{Earnings Rate}$$
(Section 805(b))

$$(2)\quad \text{Earnings Rate} \times \text{Reserves} = \text{Tax Exclusion}$$
(Section 805(a))

$$(3)\quad \frac{\text{Investment Yield}}{\text{Assets}} \times \text{Reserves} = \text{Tax Exclusion}$$
(Section 805 (a) and (b))

or

$$\text{Investment Yield} \times \frac{\text{Reserves}}{\text{Assets}} = \text{Tax Exclusion}$$

Thus, the computation of a life insurance company's taxable investment income depends upon the proportionate relationship between assets and reserves. The Act therefore "allocates investment income between [the company's] life insurance reserves and [the company's] surplus, according to the total amount of each." H.R. Rep. No. 34, *supra,* at 10. As the foregoing

[30] The statutory exclusion for "policy and other contract liability requirements" also includes amounts necessary to meet the company's pension plan reserves and to cover interest paid. See Section 805(a). The amount of the exclusion is then determined on an item-by-item basis by multiplying each item of investment income, including tax-exempt interest, by a fraction equal to the total exclusion divided by total investment yield. See Section 804 (a)(1); *United States* v. *Atlas Life Ins. Co.*, *supra*, 381, U.S. at 249.

formulae demonstrate, the company's tax exclusion is directly proportional to its "reserves" and inversely proportional to its "assets."

2. If a company makes the traditional assumption of the life insurance industry that the full premiums on all of its outstanding policies have been paid and computes its reserves—the numerator of the fraction—for purposes of the formula on the basis of that assumption, it would seriously distort the formula if it did not make the identical assumption in computing its assets—the denominator of the same fraction. Like all mathematical formulae, the Phase I computation can only produce an accurate result if each of its elements is computed in accordance with a consistent set of assumptions.

It is therefore hardly surprising that four courts of appeals have rejected the mathematical imbalance approved by the decision below. Those courts have uniformly held that if a life insurance company assumes that its premiums are fully paid and thereby overstates its reserves in its Phase I tax computations, it must likewise assume that the premiums are part of its "assets" in that computation. As the Seventh Circuit first stated in *Franklin Life Insurance Co.* v. *United States,* 399 F. 2d 757, 761 (C.A. 7), certiorari denied, 393 U.S. 1118, the inclusion of deferred and uncollected premiums in "reserves" but not in "assets" "would attribute to Congress an intention that in the same statutory equations, exclusions and deductions attributable to reserves are to be based on the assumption that the annual premium is fully paid up

and yet the amounts in the same equation from which these figures are to be subtracted are to be determined on the assumption that the annual premium is not fully paid up. * * * We perceive nothing from which intent to impose such a dual standard of tax accounting can be presumed." Accord: *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F. 2d 842, 854–856 (C.A. 4), certiorari denied, 396 U.S. 828; *Western National Life Insurance Co. of Texas* v. *Commissioner*, 432 F. 2d 298, 301–302 (C.A. 5); *Western and Southern Life Insurance Co.* v. *Commissioner*, 460 F. 2d 8, 10–14 (C.A. 6), certiorari denied, 409 U.S. 1063. See also *Bankers Union Life Insurance Co.* v. *Commissioner*, 62 T.C. 661; *United Life and Accident Insurance Co.* v. *United States*, 329 F. Supp. 765 (D. N.H.); *Union Mutual Life Insurance Co.* v. *United States*, No. 74–112 S.D., decided September 14, 1976 (D. Me.) (38 A.F.T.R. 2d 76–5802); *Midland National Life Insurance Co.* v. *Commissioner*, 66 T.C. 550.

Like the prior appellate decisions, the court of appeals in this case correctly recognized that the assumption of full premium payment is a fiction, since life insurance companies do not in fact receive annual premiums in full as of the end of the taxable year (see Pet. App. B 15a). But the court thereupon erroneously characterized the prior decisions themselves as "predicated on a fiction and a desire to achieve accounting uniformity" (Pet. App. B 16a). In so holding, the court overlooked the critical fact that the assumption of full premium payment results in an equally fictional overstatement of reserves. It is this

overstatement of reserves that requires the inclusion of the full premium in "assets," not simply as a matter of accounting uniformity, but to preserve the integrity of the Phase I formula.

As the Fourth Circuit succinctly put it in *Jefferson Standard Life Insurance Co.* v. *United States, supra*, 408 F. 2d at 856, "If the full annual net valuation premium is treated as a reserve liability under § 804, the corresponding asset should be the gross annual premium * * *; else the formula is unbalanced to the unwarranted benefit of taxpayer." In sum, if the assumption of full premium payment is accepted at all, a company must apply that assumption in computing its "assets" as well as its "reserves." If that were not the case, the Phase I formula would not accurately reflect the true proportional relationship between reserves and assets.

The decision below attempted to refute the analyses of the four circuits that have upheld the Commissioner's position on the ground that respondent was required by Oklahoma law to establish reserves for each of its policies on the assumption of full premium payment as of the end of the year. From this premise, the court concluded that while "the reserves actually exist as a liability, the unpaid premiums do not exist until actually paid" (Pet. App. B 14a). In its view, the net valuation portions of the deferred and uncollected premiums were therefore required to be included in respondent's reserves while such premiums could not be included in its "assets."

Contrary to the reasoning of the court of appeals, the reserves of a life insurance company are not book-

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keeping entries made in a vacuum apart from the company's premiums and assets. As we have pointed out in Part B, *supra,* pp. 29–33, reserves represent the company's liabilities to the policyholders only to the extent that the policyholders pay premiums which the company can use to cover its reserves. See, *e.g., New York Life Ins. Co.* v. *Edwards, supra,* 271 U.S. at 119. Moreover, it is universally recognized that the inclusion of deferred and uncollected premiums in the amount of the reserves shown on a company's annual statement does not reflect an actual liability that impairs the company's surplus (see pp. 36–37, *supra*). Thus, even accepting the court of appeals' assumption that state law required respondent to include the net valuation portion of its deferred and uncollected premiums in the computation of its reserves,[31] the Commissioner's Regulations require a consistent application of the selfsame assumption upon which that computational requirement is based, *viz.,* that all of the premiums have been paid as of the policy anniversary dates.

In sum, there is no justification for the imbalance created by the contradictory set of assumptions upon

[31] But cf. Ernst & Ernst, *GAAP—Stock Life Companies, supra,* which states (p. 450):

"There is no statutory requirement to compute mean reserves, *i.e.*, reserves which assume the receipt of an annual net premium. But companies continue to do so, primarily for ordinary insurance, in part because this approach is traditional, in part because published tables of reserve factors use the mean reserve approach, and in part because the volume of reserve factors which recognize mode and paid-to date would be so great as to constitute an administrative problem of monstrous proportions."

which the decision below rests. If the net valuation portions of the deferred and uncollected premiums are included in a company's reserves in the Phase I computation in accordance with the traditional insurance industry convention, those premiums must be deemed to have been paid and to be part of the company's assets in that computation. Treasury Regulations, Section 1.805–5(a)(4)(ii), Ex. (1).

3. a. The error of the decision below is underlined by the fact that the life insurance industry itself has never taken the extreme position of the court of appeals. In all of the appellate litigation to date under the Life Insurance Company Income Tax Act of 1959, the industry has not contended that deferred and uncollected premiums could be excluded in their entirety from "assets" under Section 805(b)(4) in the Phase I computation. To the contrary, the industry has acknowledged that deferred and uncollected premiums are includable in "assets," at least to the extent of the net valuation portion of those premiums.

The industry's position is shown by the sequence of events in *Western National Life Insurance Co. of Texas* v. *Commissioner, supra.* There, the Tax Court originally held, in conformity with the decision below in this case (50 T.C. 285, 297–300), that all deferred and uncollected premiums were excludable from "assets." However, on the Commissioner's motion for reconsideration, the Tax Court modified its decision and adopted the position of the Life Insurers Conference, the American Life Convention, and the Life

Insurance Association of America as *amici curiae* that deferred and uncollected premiums were includable in "assets" only to the extent of the net valuation portion of those premiums (51 T.C. 824). The Fifth Circuit reversed the Tax Court and upheld the Commissioner's position that the full amount of the deferred and uncollected premiums was includable in "assets." In so holding, it noted that the Tax Court's decision was in conformity with the industry's views (see 432 F. 2d at 301).[32]

The Life Insurance Council of America[33] intends to file an *amicus* brief in this case. It has advised us that it will likewise contend that deferred and uncollected premiums be included in "assets" only to the extent of the net valuation portion of such premiums. In the industry's view, as expressed in its briefs in the prior cases, the net valuation portion of the deferred and uncollected premiums should be included in "assets" to offset the reserves that are determined on a net valuation annual premium basis, but the loading element of those premiums should be excluded from "assets." In support of this treatment, the industry has relied upon the annual statement form approved by the National Association of Insurance Commis-

[32] After four circuits had rejected the approach of its modified decision in *Western National Life Insurance Co.* (51 T.C. 824), the Tax Court subsequently upheld the Commissioner's position in *Bankers Union Life Insurance Co.* v. *Commissioner*, 62 T.C. 661. Its holding here was on the authority of that latter decision (Pet. App. A 7a–8a).

[33] The American Life Convention and the Life Insurance Association of America have merged. The successor organization is the Life Insurance Council of America.

sioners and employed by the insurance departments of most States (see Exs. E, F, H, A. 60–61, 75–76, 90–91).

Pursuant to the NAIC form, an insurance company offsets the overstatement of its reserves in the amount of the net valuation portion of the deferred and uncollected premiums by creating an asset equal in amount called "Life insurance premiums and annuity considerations deferred and uncollected." This asset is the gross amount of these premiums minus the loading element. However, as we pointed out in our discussion of the origins of this accounting convention (see pp. 34–37, *supra*), the sole consideration underlying the NAIC form is to provide an accurate picture of the company's solvency. Thus, if the company assumes receipt of the full annual premium and thereby overstates its reserves by the net valuation portion of those premiums, the solution devised by the NAIC form is to establish an asset to offset the overstatement of the reserves. The net effect of such offsetting entries is the same as if the deferred and uncollected premiums were disregarded for all purposes on the company's annual statement. See Wightman, *supra*, at 373–375.

But the NAIC goal of achieving an accurate report of a company's solvency is entirely unrelated to the purpose of the Phase I tax computation, which is designed to measure the proportional relationship of the company's assets and reserves. As this Court stated in *McCoach* v. *Insurance Company of North America*, 244 U.S. 585, 589: "The act of Congress, on the other hand, deals with reserves not particularly in

their bearing upon the solvency of the company, but as they aid in determining what part of the gross income ought to be treated as net income for purposes of taxation."

If a life insurance company assumes that the deferred and uncollected premiums on all of its policies have been paid as of their anniversary dates and increases its reserves for tax purposes by the net valuation portion of such premiums, that assumption necessarily stands on the hypothesis that the company has received the *full* amount of those premiums and not some lesser amount. Put another way, since the policyholder pays the gross amount of the premium and not the net valuation portion, it is the gross premium that must be included in the company's "assets."[34]

b. Nor does Section 818(a) of the Code, upon which the industry has relied in the prior cases, support a different result. that statute provides that life insurance companies must make all tax computations "under an accrual method of accounting." The last sentence of Section 818(a) states: "Except as pro-

[34] The NAIC financial reporting method is basically incompatible with the Phase I formula. The NAIC inclusion of equal net valuation amounts in both "reserves" and "assets" for deferred and uncollected premiums would distort the proportional relationship of reserves to assets by erroneously assuming that these two elements increase in numerically equivalent amounts. This contrary-to-fact assumption would in turn distort the Phase I formula by increasing the fraction $\frac{\text{Reserves}}{\text{Assets}}$. See *Franklin Life Insurance Co. v. United States*, *supra*, 399 F. 2d at 760. The result would allocate a greater portion of investment income to the policyholder reserves and a lesser amount to the company's surplus than is justified by the actual facts.

vided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners." The industry has contended that this reference to the NAIC annual statement provides statutory authority for the adoption of the NAIC's treatment of deferred and uncollected premiums for tax purposes.

But the language of the statute makes clear that the NAIC treatment of a particular item is only to be accepted when it is consistent with an accrual method of accounting. See H.R. Rep. No. 34, *supra*, at 42; S. Rep. No. 291, *supra*, at 72–73. The NAIC treatment, however, is not an accrual method of accounting within the accepted meaning of that term. It assumes receipt of the gross deferred and uncollected premiums only for purposes of the reserve liabilities, but does not correspondingly treat the full amount of those premiums as receivables on the assets side of the balance sheet. As the Fifth Circuit correctly observed, "In point of fact, the N.A.I.C. method is a hybrid method and not strictly an accrual method." *Western National Life Insurance Co. of Texas* v. *Commissioner*, *supra*, 432 F. 2d at 301. Without the assumption of full premium payment, deferred and uncollected premiums would not be properly accruable under an accrual method of accounting. But once the assumption of full premium payment is made, an accrual method of accounting requires that these premiums be taken into account consistently for assets as well as liabilities.

The courts of appeals have therefore correctly rejected the insurance industry's attempt to impose the NAIC method of accounting upon the Internal Revenue Code. As the Seventh Circuit observed in *Franklin Life Insurance Co.* v. *United States, supra,* 399 F. 2d at 760, "The careful and detailed attention given by Congress throughout Sections 801 through 820 to definition of the particular items utilized as factors in the tax formula and in specifying and enumerating the permissible deductions and exclusions negates the existence of any intent on the part of Congress to relegate the substantive matter of offsetting or excluding loading on deferred and uncollected premiums, with its concomitant impact on the resulting tax, to the NAIC." [35] Accord: *Jefferson Standard Life Insurance Co.* v. *United States, supra,* 408 F. 2d at

[35] The limited role of the NAIC method of financial reporting is confirmed by the position the insurance industry took during the hearings on the 1959 Act. At that time, the industry stressed that the NAIC annual statement and the annual statement's Summary of Operations were "intended only for use * * * as a measure of solvency and not for use as a year-to-year measure of earned income for tax purposes." See Hearings on H.R. 4245 (Tax Formula for Life Insurance Companies) before the Senate Committee on Finance, 86th Cong., 1st Sess. 302 (1959) (Statement of Francis V. Keesling, Jr.). Likewise, Claris Adams, who was General Counsel of the American Life Convention, stated during the House hearings (Hearings on the Taxation of Income of Life Insurance Companies before the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, 85th Cong., 2d Sess. 56 (1958):

"It follows that the results in any given year, as shown by a life insurance company's annual statement, are so much of the product of estimates of future liabilities based on probabilities that the results themselves are essentially estimates instead of actualities.

"As a matter of fact, the annual statement of life insurance companies as designed by the National Association of Insurance Commissioners does not show, and never was intended to show, yearly profit and loss on company operations, but has only been constructed to reflect an overall standard of probable solvency. It cannot be too strongly emphasized that the annual statement of life insurance companies is not a profit-and-loss statement."

849–850, 856; *Western National Life Insurance Co. of Texas* v. *Commissioner, supra,* 432 F. 2d at 301–302; *Western and Southern Life Insurance Co.* v. *Commissioner, supra,* 460 F. 2d at 12–14.

D. A LIFE INSURANCE COMPANY THAT INCLUDES THE NET VALUATION PORTION OF DEFERRED AND UNCOLLECTED PREMIUMS IN "RESERVES" MUST INCLUDE THE GROSS AMOUNT OF SUCH PREMIUMS IN ITS COMPUTATION OF "GROSS AMOUNT OF PREMIUMS" UNDER SECTION 809(C)(1)

1. The necessity for consistency of assumptions applies with equal force to the Phase II computation of a life insurance company's "gain from operations" under Section 809. As we have pointed out *supra,* pp. 7–8, the company's "gain from operations" includes its income from all sources less certain specified deductions. Since "gain from operations" includes an element of investment income (see Section 809(b)(1)(A)), the further computation of "gain from operations" is directed toward taking into account income from other sources, principally underwriting income. A company has underwriting gains when the premiums it charges for policies are in excess of its costs in providing the coverage.

The Section 809 computation of "gain from operations" involves totalling the company's income items and offsetting that amount by its deductions in essentially the same manner as any other computation of net income. In addition to the company's share of

investment income, the income items include "gross amount of premiums," net decreases in reserves, and other amounts (Section 809(c)). The specified deductions include non-investment expenses, such as underwriting expenses, salaries, and general overhead, and claims paid (Section 809(d)). In accord with the congressional decision to exclude from the tax base that portion of premiums necessary to meet future claims, Section 809(d)(2) permits a deduction for increases in reserves that are attributable to premiums included in income under Section 809(c)(1). After subtracting the various deductions from the company's gross income from all sources, the resulting figure is its "gain from operations."

The court of appeals' holding that respondent was not required to include any part of the deferred and uncollected premiums in "gross amount of premiums" under Section 809(c)(1) suffers from the same infirmity as its exclusion of those premiums from "assets" under Section 805(b)(4). As the mechanics of the Phase II computation demonstrate, Section 809(d)(2) allows a deduction for increases to reserves. Thus, if an insurance company computes its reserves on the traditional assumption of full premium payment and claims a Section 809(d)(2) deduction for those reserves, it must likewise apply that assumption to the income side of the tax computation and include the full amount of the deferred and uncollected premiums in "gross amount of premiums" under Section 809(c)(1). Treasury Regulations, Section 1.809-4(a); *Franklin Life Insurance Co.* v. *United States, supra,* 399 F. 2d at 760–761; *Jefferson Standard Life Insurance Co.* v. *United States, supra,* 408 F. 2d at 855–856; *Western National Life Insurance Co. of Texas* v. *Commissioner, supra,* 432 F. 2d at 301–302; *Western and Southern Life Insurance Co.* v. *Commissioner, supra,* 460 F. 2d at 11–14. If the deferred and uncollected premiums are not included in income, there is no warrant for the deduction for reserves attributable to such premiums. The integrity of a computation of net income requires that uniform assumptions be made with respect to both income and deduction items.

2. Thus, the decision of the court of appeals cannot be justified on any rational basis. But the insurance industry has contended in the prior cases, and presumably the *amicus* Life Insurance Council will likewise urge here, that it is entitled to a deduction or offset for loading on deferred and uncollected premiums so that such premiums are included in income in the Phase II computation only to the extent of the net valuation portion. In support of this approach, the industry again invokes the authority of the NAIC method of financial reporting.

As we have shown with respect to the Phase I computation (see pp. 34–37, 47, *supra*), the sole concern of the NAIC method is to project an accurate report of the company's solvency. Thus, on the NAIC form entitled "Summary of Operations," the company includes its gross deferred and uncollected premiums in "Premiums and annuity considerations" (line 1.1) and deducts: (1) the net valuation portion in "Increase in aggregate reserve for policies and contracts with life

contingencies" (line 17); and (2) the loading element in "Increase in loading on * * * deferred and uncollected premiums" (line 25) (see Ex. F, A. 77). The net effect of these computations is to cancel out any impact of deferred and uncollected premiums on the company's income statement because the additions on the income side exactly equal the subtractions on the deductions side.

The courts of appeals have properly rejected, as inconsistent with the language of the statute, the industry's position that only the net valuation portion of the deferred and uncollected premiums be included in income. Section 809(c)(1) requires the inclusion in income of the "*gross* amount of premiums" and not any lesser amount. Moreover, the NAIC deduction for the company's increase in loading on deferred and uncollected premiums is not one of the deductible items specified in Section 809(d). Since "a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms" (*New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440),[36] there is no basis for the industry's claim to a nonstatutory tax deduction for the net increase in loading.

E. ALTERNATIVELY, IF DEFERRED AND UNCOLLECTED PREMIUMS ARE NOT INCLUDED IN "ASSETS" AND "GROSS AMOUNT OF PREMIUMS," THE NET VALUATION PORTION OF THOSE PREMIUMS MUST LIKEWISE BE EXCLUDED FROM "RESERVES"

The core of our submission in this case is that a life insurance company must treat its deferred and uncollected premiums for federal tax purposes in accordance with a consistent set of assumptions. Recognizing the industry-wide assumption that premiums have been paid in full as of the anniversary dates of the policies and that the computation of reserves will be made in accordance with that assumption, the pertinent Treasury Regulations (Sections 1.805–5(a)(4)(ii) and 1.809–4(a)) likewise properly require that deferred and uncollected premiums be included in "assets" and "gross amount of premiums." In this manner, the assumption of full premium payment will be given effect for all of the elements of the federal tax computations.

As noted (pp. 34–37, *supra*), the asumption of full premium payment is a financial reporting convention adopted by the life insurance industry to simplify the actuarial determinations of its year-end reserves. To the extent that the reserves reflect the net valuation portion of the deferred and uncollected premiums, they are overstated and represent no actual liability of the company. The company is only liable to pay the benefits for periods with respect to which the premiums have actually been paid. Indeed, the NAIC accounting device of creating a "quasi-asset" equal to the net valuation portion of the deferred and uncollected premiums to offset the overstatement of the reserves convincingly demonstrates that the overstatement of the reserves does not encumber any real assets of the company.

If the industry-wide assumption of full premium payment were disregarded for purposes of the federal tax computation, consistency could nevertheless be

[36] The Court has likewise invoked the principle that deductions must be supported by a particular statute in connection with the taxation of life insurance companies. See *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, 381.

achieved by excluding deferred and uncollected premiums from "reserves," "assets," and "gross amount of premiums." This alternative approach is set forth in Treasury Regulations, Section 1.801–4(f), which provides that if it is determined that deferred and uncollected premiums are not properly includable in "gross amount of premiums" and "assets," then "apporpriate reduction shall be made in the life insurance reserves."

In prescribing this alternative method, the Regulations make certain that if deferred and uncollected premiums are not to be included in "assets" and "gross amount of premiums," as the decision below has held, the net valuation portion of those premiums cannot be included in "reserves." Thus, the alternative approach would continue to guarantee the integrity of the tax computations.

The exclusion of deferred and uncollected premiums altogether from "assets," "gross amount of premiums," and "reserves" is arguably more consistent with the decisions of the Court recognizing that a life insurance reserve arises only upon the payment of premiums (see pp. 29–31, *supra*). Since the policyholder has not paid the deferred and uncollected premiums and has no legal obligation to do so, there are in fact no premiums to be included in "assets" or "gross amount of premiums." Likewise there are no amounts which are "set aside" (Section 801(b)(1)(B)) or "reserved from premiums" that would support the existence of a reserve. See *New York Life Ins. Co.* v. *Edwards, supra,* 271 U.S. at 119.

Thus, the exclusion of deferred and uncollected premiums from these three elements in the tax computations has much to commend it as a matter of absolute logic. Moreover, the seminal opinion of the Seventh Circuit in *Franklin Life Insurance Co.* v. *United States, supra,* 399 F. 2d at 761, acknowledged that "[i]f the fictional assumption were not indulged and only those reserves were accrued as were attributable to paid up portions of annual premiums, then the problem from an accrual standpoint would be simpler."

On this dual rationale of logic and simplicity, a trial judge of the Court of Claims has recently held that deferred and uncollected premiums are not includable in "assets," "gross amount of premiums," or "reserves," in accord with the alternative approach of Treasury Regulations, Section 1.801–4(f). See *Monumental Life Insurance Co.* v. *United States,* No. 71–73, decided November 19, 1976 (Ct. Cl.) (76–2 U.S.T.C. ¶ 9787). But despite the logic and simplicity of total exclusion of deferred and uncollected premiums, the Commissioner is willing to accept the life insurance industry's fictional assumption of full premium payment and consequent overstatement of reserves as long as the same assumption is consistently applied in computing the other elements of the tax formula.

Hence, our primary postion, as set forth in Treasury Regulations, Sections 1.805–5(a)(4)(ii) and 1.809–4(a)(1), is that gross deferred and uncollected premiums must be included in "assets" and "gross amount of premiums" if the net valuation por-

tion of such premiums is to be included in "reserves." However, if the Court disagrees with our submission that the full amount of deferred and uncollected premiums be included in "assets" and "gross amount of premiums," the proper disposition of this case would be to exclude such premiums entirely from the tax computations, in accordance with Treasury Regulations Section 1.801–4(f).

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1958 ed., Supp. II)):

SEC. 801 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

* * * * *

(b) *Life Insurance Reserves Defined.*—

(1) *In general.*—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) *Reserves must be required by law.*—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium

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payment plan, continuing for life and not subject to cancellation,

(B) in the case of policies issued by an organization which meets the requirements of section 501(c)(9) other than the requirement of subparagraph (B) thereof, and

(C) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

* * * * *

SEC. 802 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959 *supra.*] TAX IMPOSED.

(a) *Tax Imposed.*—

(1) *In General.*—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11 (b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

* * * * *

(b) *Life Insurance Company Taxable Income Defined.*—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

SEC. 804 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. TAXABLE INVESTMENT INCOME.

(a) *In General.*—

(1) *Exclusion of policyholders' share of investment yield.*—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) *Taxable investment income defined.*—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent.

* * * * *

(b) *Gross Investment Income.*—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) *Interest, etc.*—The gross amount of income from—

(A) interest, dividends, rents, and royalities,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

(2) *Short-term capital gain.*—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

(3) *Trade or business income.*—The gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.*—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

(2) *Real estate expenses.*—The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(3) *Depreciation.*—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence)

as the rental value of the space not so occupied bears to the rental value of the entire property.

(4) *Depletion.*—The deduction allowed by section 611 (relating to depletion).

(5) *Trade or business deductions.*—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph—

(A) There shall be excluded losses—

(i) from (or considered as from) sales or exchanges of capital assets,

(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) from the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

(C) The deduction for net operating losses provided in section 172, and the

special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

SEC. 805 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) *In General.*—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) *Adjusted Reserves Rate and Earnings Rates.*—

(1) *Adjusted reserves rate.*—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) *Current earnings rate.*—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) *Average earnings rate.*—

(A) *In general.*—For purposes of this part, the average earnings rate for any

taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(B) *Special rules.*—For purposes of subparagraph (A)—

(i) the current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if this part (as in effect for 1958) and section 381(c)(22) applied to such taxable year, and

(ii) the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall be determined as if this part applied to such company for such year.

(4) *Assets.*—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

(A) real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of de-

termining gain on sale or other disposition.

(c) *Adjusted Life Insurance Reserves.*—

(1) *Adjusted life insurance reserves defined.*—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rate.

(2) *Average interest rate assumed.*—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

* * * * *

SEC. 809 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. IN GENERAL.

(a) *Exclusion of Share of Investment Yield Set Aside for Policyholders*—

(1) *Amount.*—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(2) *Required interest.*—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) *Gain and Loss From Operations.*—

(1) *Gain from operations defined.*—For purposes of this part, the term "gain from operations" means the amount by which the sum of the

following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (e).

(2) *Loss from operations defined.*—For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

(3) *Life insurance company's share.*—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

(4) *Exception.*—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(c) *Gross Amount.*—For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) *Premiums.*—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) *Decreases in certain reserves.*—Each net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

(3) *Other amounts.*—All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(1) *Death benefits, etc.*—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) *Increases in certain reserves.*—The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

(3) *Dividends to policyholders.*—The deduction for dividends to policyholders (determined under section 811(b)).

(4) *Operations loss deduction.*—The operations loss deduction (determined under section 812).

(5) *Certain nonparticipating contracts.*—An amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating

contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

(6) *Group life, accident and health insurance.*—An amount equal to 2 percent of the premiums for the taxable year attributable to group life insurance contracts and group accident and health insurance contracts. The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts.

(7) *Assumption by another person of liabilities under insurance, etc., contracts.*—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(8) *Tax-exempt interest, dividends, etc.*—

(A) *Life insurance company's share.*—Each of the following items:

(i) the life insurance company's share of interest which under section

103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804 (a)(3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

(B) *Application of Section 246(b).*—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A)(iii), the limit on the aggregate amount of the deductions allowed by sections 243 (a), 244, and 245 shall be 85 percent of the gain from operations computed without regard to—

(i) the deductions provided by paragraphs (3), (5), and (6) of this subsection,

(ii) the operations loss deduction provided by section 812, and

(iii) the deductions allowed by sections 243(a), 244, and 245,

but such limit shall not apply for any taxable year for which there is a loss from operations.

(9) *Investment expenses, etc.*—Investment expenses to the extent not allowed as a deduction under section 804(c)(1) in computing investment yield, and the amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income.

(10) *Small business deduction.*—A small business deduction in an amount equal to the amount determined under section 804 (a)(4).

(11) *Certain mutualization distributions.*—The amount of distributions to shareholders made in 1958 and 1959 in acquisition of stock pursuant to a plan of mutualization adopted before January 1, 1958.

(12) *Other deductions.*—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

* * * * *

SEC. 810. [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. RULES FOR CERTAIN RESERVES.

(a) *Adjustment for Decrease.*—If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the excess shall be taken into account as a net decrease referred to in section 809(c)(2).

(b) *Adjustment for Increase.*—If the sum of the items described in subsection (c) as of the

close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2).

(c) *Items Taken Into Account.*—The items referred to in subsections (a) and (b) are as follows:

(1) The life insurance reserves (as defined in section 801(b)).

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2).

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

(5) Premiums received in advance, and liabilities for premium deposit funds.

* * * * *

SEC. 818 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. ACCOUNTING PROVISIONS.

(a) *Method of Accounting.*—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

* * * * *

(f) *Denial of Double Deductions.*—Nothing in this part shall permit the same item to be deducted more than once under subpart B and once under subpart C.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.801–4. *Life insurance reserves.*

* * * * *

(f) *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as de-

fined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

§ 1.805–5 *Adjusted reserves rate and earnings rates.*

(a) *In general.* * * *

* * * * *

(4) *Assets*—(i) *Definition.* Section 805(b)(4) defines the term "assets" as meaning all assets of the life insurance company (including nonadmitted assets), other than real and personal property (excluding money) used by the life insurance company in carrying on an insurance trade or business. For purposes of the preceding sentence, the term "money" includes cash, currency, bank deposits (including time deposits) whether or not interest bearing, share accounts in savings and loan associations, checks (whether or not certified), drafts, money orders, and any other item of similar nature. * * *

* * * * *

(ii) *Illustration of principles.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds, stocks, mortgages, home office and branch office buildings owned and wholly occupied by the company, furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations. For purposes of section 805(b)(4) and this subparagraph, the home office and branch office buildings owned and wholly occupied by the company, and the furniture and equipment owned by the company and used by it in connection with the operations conducted in the home office and branch office buildings occupied by the company, shall be excluded from the term "assets" since such items are the only ones considered as being used by P in carrying on an insurance trade or busineess. Accordingly, since bonds, stocks, mortgages, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations are not considered as being used by P in carrying on an insurance trade or business, they are included within the term "assets" and, therefore, shall be taken into account by P in determining its current earnings rate.

* * * * *

§ 1.809–4. *Gross amount.*

(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively, section 809(c) specifies three categories of items

which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809(a)(1) paragraph (c) of § 1.809–2), * * *. The additional three categories of items taken into account are:

(1) *Premiums.* (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an

assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of § 1.809–5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)).

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